State of California
Franchise Tax Board

05.05.09

To: Anne Miller, Chief
Filing Division

From: Philip Yu

Subject: Review of the Personal Income Tax (PIT) Penalties assessed by the Taxpayer Information System (TI)

Introduction

We have completed our review of the PIT Penalties assessed by the Taxpayer Information System (TI) for taxable years 2003 to 2006.

You requested Internal Audit to perform a review of the Personal Income Tax (PIT) penalties in order to provide assurance that the Taxpayer Information System is performing the correct PIT penalty calculations.

Background

The Franchise Tax Board (FTB) imposes basically three different types of penalties: account (automatic) penalties that are issued by notice and demand (typically a bill), audit and federal action penalties that must be issued by Notices of Proposed Assessment, and miscellaneous penalties.

Account penalties are imposed automatically by FTB's computer system during return processing and when various account actions are taken. The vast majority of the penalties that FTB issues are computer-generated account penalties. These penalties arise by operation of law when certain conditions on a taxpayer's account exist. As a general rule, they are "due and payable" when the bill is issued and do not have formal prepayment protest rights. However, except for the estimated tax penalty, they generally can be abated upon a showing of reasonable cause. In addition, where the underlying tax liability is reduced, there is often a reduction in the associated penalty. All penalties are created by legislation.

Legislative changes to PIT penalties in TI are incorporated into the PIT Annual Change Control Process that generally implements system changes due to indexing and legislation chaptered into law. The PIT Annual Change Control Process includes the following:

- A PIT Annual Changes Implementation Plan for the implementation of legislation.

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- Change Control procedures that include approvals, documentation, walkthroughs of business requirements and testing results, testing and signoffs by stakeholders that include business areas, programmers, testers, and their managers.

- A Production Review Procedure Manual with procedures on post-production follow-ups with users as well as post-annual reviews on annual change modifications to TI.

Scope

The scope of this review includes penalties assessed by the Taxpayer Information System for taxable years 2003 through 2006.

Objectives

The objective of our review is to determine whether:

- The PIT Penalties are calculated correctly by TI, and

- The PIT Penalty Change Control Process has proper controls in place.

Methodology

To determine whether PIT Penalties are calculated correctly in TI, we conducted a risk assessment of PIT penalties and identified four types of penalties as high risk due to their complex computation and their high volume and assessed amounts. These four types of penalties include:

- The Late Filing or Delinquent Penalty,

- The Demand Penalty,

- The combined Underpayment and Monthly Penalty, and

- The Underpayment of Estimated Tax Penalty, commonly referred to as the Estimate Penalty.

For each of the high-risk penalties, we selected a total of fifteen random samples (three from the 2003 tax year and four samples each for the 2004, 2005, and 2006 tax years) to determine whether the penalties programmed in TI match the provisions of various legislation.

To review proper controls in the PIT Penalty Change Control Process, we initiated the following:

- Interviewed both management and staff in the Tax Systems and Applications Bureau (TSAB) who are responsible for programming changes to TI

- Verified that TSAB has procedures in place for the PIT Penalty Change Control Process

- Compared Legislative Change Notices impacting PIT penalties (mandated changes) to the PIT Annual Change Packages (for all annual system changes) and Production Changes (due to production/technical issues) requested by users.

Results

PIT Penalties identified as High Risks

There were no exceptions in the samples we tested on the Late Filing (Delinquent) Penalty, the Demand Penalty, and the combined Underpayment and Monthly Penalties. Our test samples on these three types of penalties revealed that they were calculated correctly in TI. In addition, the PIT Penalty Change Control Process on these penalties has proper internal controls in place. These internal controls are effective both in design and in operation.

In 2002, Assembly Bill (AB) 1122 amended California Revenue & Taxation Code (CR&TC) Section 19136 to conform to the Federal estimated payment requirements for years beginning with the 2002 taxable year. However, AB 1122 waived any underpayments of estimated tax for any period before 4/15/03, with respect to any underpayment for the 2002 taxable year. Therefore, conformity to the Federal estimated payment requirements, for practical purposes, began with the 2003 taxable year.

Specifically, AB 1122 eliminated the two “80% subject to withholding” safe harbors and conformed to the Federal 90% of the current year tax liability safe harbor. Safe harbor is a provision of a statute that reduces or eliminates a taxpayer’s liability under the law, that is, it provides an exception to the law. California’s conformity to the Federal 90% of the current year tax liability safe harbor means a taxpayer will be required to pay a higher amount of estimated tax from the previous 80% to 90% of the current year’s tax to avoid the estimate penalty.

On an annual basis, the Tax Systems & Applications Bureau (TSAB) incorporates system changes to TI resulting from bills that are chaptered into law. The TI system changes to eliminate the two “80% subject to withholding” safe harbors required by AB 1122 were not implemented during the 2004 PIT Annual Changes for the 2003 tax year because the business requirements were not properly written and reviewed. This system error was not discovered until July 2006. As a result of not making this change, 240,785 PIT accounts in TI were identified that may have had estimate penalties erroneously refunded or reduced for tax years 2003 through 2005 with an estimated loss of $6,527,719 million in revenue.

An estimate of the costs to verify and bill all 240,785 PIT accounts was made. The total cost that included pulling tax returns, reviewing accounts, creating notices, postage on mailing notices, and answering taxpayers' calls amounted to $3,749,736. The return on investment was 1:1.74, i.e., for every $1 spent, 1.74 in revenue may be generated.

In view of the relatively small benefit compared to the costs, a joint decision was made by FTB's Executive Management Team to change the estimate penalty computation on a prospective basis for tax year 2006 and beyond.

In January 2008, TSAB introduced a signoff by stakeholders that include business areas, programmers, testers, and their managers for tasks accomplished on system changes. The signoff satisfies the dual purpose of preventing future system error and as an element of accountability.

Internal Audit reviewed the estimate penalty changes made and a detailed plan developed by the Test System Testing Section of TSAB and found that they are adequate to ensure future changes to the estimate penalty are identified and appropriately changed in TI.

Conclusion

Based on our review on penalties assessed in TI, we conclude the internal controls are sufficient to meet the objectives stated above.

We greatly appreciate the cooperation and assistance provided by Tax Systems and Applications Bureau staff. If you have any questions, please contact Wendy Lahey at (916) 845-7821.

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